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## Private Law: Banking Law

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## DEVELOPMENTS IN THE LAW, 1979-1980

### *A Symposium*

[*Editor's Note.* The title of this symposium has been changed from *The Work of the Louisiana Appellate Courts for the Term to Developments in the Law* to reflect expanded coverage of legislative amendments in Louisiana and of federal statutes and decisions of interest to the Louisiana lawyer. However, the symposium continues to cover primarily decisions of Louisiana courts.]

## PRIVATE LAW

### BANKING LAW

*Ronald L. Hersbergen\**

#### HOLDER IN DUE COURSE STATUS

##### *Federal Preservation of Consumers' Claims and Defenses*

The Federal Trade Commission (FTC) concluded in November of 1975, after reviewing a public record of more than 2,000 pages of testimony and 700 pages of written submissions generated by two and one-half years of public proceedings, that it constitutes an "unfair and deceptive practice" within the meaning of 15 U.S.C. § 45(a)(1) for sellers of consumer goods or services (affecting interstate commerce) to utilize contract stipulations or contract forms that separate the consumer's duty to pay for such goods or services from the seller's reciprocal duty to perform as promised. The typical situation at which the FTC took aim was the transfer of a negotiable promissory note by the seller to a holder in due course whose status as such permitted the cutoff of the buyer's claims and defenses.<sup>1</sup> To remedy the perceived unfairness and deception,<sup>2</sup> the FTC in 1975

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1. LA. R.S. 10:3-305 (Supp. 1974).

2. The FTC had long felt that it was unfair and deceptive for sellers to fail to warn consumers that the contracts signed by them would be sold to third parties who (by virtue of holder in due course status or as beneficiary of a "waiver of claims and defenses" clause) might be permitted to enforce the consumer's obligation without regard to claims and defenses. See 38 Fed. Reg. 892 (1973); Note, *The FTC Proposed Rule and the Holder in Due Course*, 18 S. DAK. L. REV. 516 (1973). The Commission presumably would say that it is *unfair* to separate the parties' reciprocal obligations to perform, and *deceptive* to do so by use of a sophisticated commercial document with

produced a Trade Regulation Rule<sup>3</sup> requiring the presence of a prescribed preservation of claims and defenses clause on all consumer contracts.<sup>4</sup>

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the legal niceties of which the consumer is not likely to be acquainted.

The National Commission on Consumer Finance, in its 1972 report on consumer credit, included among its recommendations that third party holders of contracts and other evidences of indebtedness should be subject to all claims and defenses of the consumer-debtor arising out of the transaction—in short, the abolition of holder in due course protection in consumer contracts. CONSUMER CREDIT IN THE UNITED STATES, xvii & 34-38 (U.S. Gov't Printing Office Stock No. 5200-00005, December, 1972).

3. The FTC had previously assumed the power to make substantive "trade regulation rules" to enhance its ability to protect consumers from unfair or deceptive trade practices, but the Commission had been challenged on this point. See *National Petroleum Ref. Ass'n v. Federal Trade Comm'n*, 340 F. Supp. 1343 (D.D.C. 1972), *rev'd*, 482 F.2d 672 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 951 (1974). When the district court in *National Petroleum Ref.* had refused to recognize the power asserted by the FTC, the Congress initiated action to enlarge the statutory authority of the Commission; the United States Court of Appeals subsequently reversed the decision of the district court, siding with the Commission. The Congressional initiative culminated in the FTC Improvement Act, 15 U.S.C.A. § 57(a) (1979), which gave to the Commission the power to make substantive trade regulation rules. The Act, however, expressly revokes the nonlegislative power asserted by the Commission in the *National Petroleum Ref.* litigation. 15 U.S.C.A. § 57(a)(2) (1979).

4. 16 C.F.R. § 433 (1979). Technically, the Rule makes it an "unfair or deceptive practice" within the meaning of section 5 of the FTC Act for a seller, directly or indirectly, to take or receive a "consumer credit contract" which fails to contain the FTC's required clause:

NOTICE—

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER

or to accept, as full or partial payment for such sale or lease, the proceeds of any purchase money loan (as defined), unless any consumer credit contract made in connection with such purchase money loan contains the following provision:

NOTICE—

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

"Consumer credit contract" is defined under the Rule as an instrument which evidences or embodies a debt arising from a cash advance received by a consumer (a natural person who seeks or acquires goods or services for person, family, or household use) in return for "finance charge" (within the meaning of Truth in Lending and Regulation Z), and which is applied in whole or in part, to a purchase of goods or services from a seller who refers consumers to, or is affiliated or has a "business arrangement" with the lender; or a debt arising from an extension of sale credit within the meaning of Truth in Lending and Regulation Z, if seller, in the ordinary course of business, sells or leases goods or services to consumers. See 41 Fed. Reg. 34594-97

The Rule, entitled "Preservation of Consumers' Claims and Defenses," immediately raised three questions of interest to lawyers: 1) Does the presence of the FTC clause in an otherwise negotiable writing preclude holder status—and therefore holder in due course status<sup>5</sup>—by destroying the negotiable character<sup>6</sup> of the

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(Aug. 16, 1976); 41 Fed. Reg. 20022-27 (May 14, 1976); 40 Fed. Reg. 53506-30 (Nov. 18, 1975).

5. It is pursuant to R.S. 10:3-305 that a holder in due course is afforded protection from the claims and defenses of the maker, and it is pursuant to R.S. 10:3-302, 3-303, and 3-304 that the status of holder in due course is attained. Each of the referenced sections concerns a "holder," a status acquired by a third party only through the process of "negotiation" described in R.S. 10:3-202(1). All of the sections mentioned require the presence of an "instrument," which for purposes of those sections means a *negotiable* instrument. LA. R.S. 10:3-102(1)(e) & 3-104 (Supp. 1974); *Leininger v. Anderson*, 255 N.W.2d 22 (Minn. 1977). Thus, one cannot be the "holder" (and therefore not the "holder in due course") of an evidence of indebtedness that is not in negotiable form under R.S. 10:3-104.

6. A plausible argument can be constructed that the FTC clause conditions the maker's undertaking, thereby destroying the negotiable character of the writing under R.S. 10:3-104(1)(b). The following cases would be helpful to the argument: *American Sur. Co. v. Federal Reserve Bank of Kansas City*, 29 F. Supp. 940 (W.D. Mo. 1939) (a memorandum that is more than a mere notation on the check or note and which constitutes a limitation or a restriction on payment destroys negotiability; but words such as "in full payment" are merely notations of receipt of payment, not intended to limit or condition payment); *Jennings v. First Nat'l Bank*, 13 Colo. 417, 22 Pac. 777 (1889) (note "not to be paid unless I have the use of said premises," held nonnegotiable); *Farmers' State Bank of Cuba v. Blazek*, 115 Kan. 178, 222 Pac. 748 (1924) (promissory writing bearing on its face the words, "subject to purchase Cuba Elevator" was conditional and nonnegotiable); *Robbins v. Life Ins. Co. of Va.*, 169 Tenn. 507, 89 S.W.2d 340 (1936) (an otherwise negotiable note for payment of rent was held to have been rendered nonnegotiable by a state statute exonerating a lessee from liability for rent where the leased premises are destroyed or so damaged as to be unfit for occupancy); *Hight v. McCulloch*, 150 Tenn. 117, 263 S.W. 794 (1924) (provision in rent note, stating "this note void in case the property is destroyed before maturity" conditioned the maker's promise, rendering the note nonnegotiable); *Anderson v. Bing*, 244 S.W.2d 187 (Tenn. App. 1951) (earnest money check reciting on its face "check to be returned if deal is not consummated" was not negotiable); *Embry v. Federal Credit Bureau*, 39 S.W.2d 906 (Tex. Civ. App. 1931) (note provision requiring notice to maker of assignment destroyed negotiability). Thus, the FTC clause can be seen as making the consumer's note a declaration that, although he has promised to pay, he has not promised to pay in all events, under all circumstances. *Cf. Hull v. Angus*, 60 Ore. 95, 118 Pac. 284, 286 (1911) (involving a note made conditional by a "subject to" clause). But the FTC could simply have required the word "nonnegotiable" on all consumer contracts, if nonnegotiability was desired. *See Henry v. Cobb Bank & Trust Co.*, 261 S.E.2d 459 (Ga. App. 1979). Moreover, no note is ever completely unconditional, because implicit in every promise to pay is the caveat, "unless, of course, I have been discharged in bankruptcy, or am declared to have been mentally incompetent on this date, or you have committed on me a 'real' fraud." To expressly state such implicit caveats would do no damage to negotiability, but of course the FTC language arguably goes beyond the express statement of an implicit condition, for the consumer today is warning the payee and all others that he is promising to pay "unless I have a claim or defense," or

writing, or, does the clause simply constitute a stipulation that affects liability, but not negotiable character, in the manner of stipulations such as those pertaining to solidarity, waiver of presentment, place of presentment, and effect of indorsements?; 2) What is the result when the clause is mistakenly inserted into an otherwise negotiable writing that is not a "consumer contract"?;<sup>7</sup> and 3) What is the result when the clause is omitted from an otherwise negotiable consumer contract? The Supreme Court of Louisiana, in *Jefferson Bank & Trust Co. v. Stamatiou*,<sup>8</sup> has, in one of the first cases in the nation to address these issues, offered a thoughtful and correct analysis.

The maker in *Stamatiou* signed a promissory note in connection with his purchase of a truck to be used in his business.<sup>9</sup> Neither the "Sale and Chattel Mortgage" nor the promissory note affixed thereto<sup>10</sup> indicated the buyer's intended use of the truck, and despite the absence of any requirement that he do so, the seller had utilized a form containing the FTC clause.<sup>11</sup> The seller assigned the contract to Jefferson Bank, and when the buyer refused to make payments (because of certain alleged redhibitory vices of the truck), litigation followed. In that litigation, Jefferson Bank sought holder in due course protection.

The Supreme Court of Louisiana resolved the holder in due course issue against the bank, making the following points: 1) The FTC clause in a non-consumer contract cannot be treated as merely informational verbiage, but must be treated as a stipulation carrying potentially important legal consequences; 2) Despite the fact that the clause appeared in the contract only in deference to assumed federal penalties for noncompliance,<sup>12</sup> the clause became part of the contract and had, under the provisions of the Civil Code, the effect of law on the parties; 3) While as between seller and buyer there

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"subject to my ability to avoid payment by the assertion of a claim or defense." A negotiable note without the FTC clause carries the opposite connotation, to wit, "I promise to pay a holder in due course *despite* the existence of claims or defenses I might have against the payee."

7. See note 4, *supra*.

8. 384 So. 2d 388 (La. 1980).

9. The opinion does not suggest that the buyer disputed the allegation that his intended purpose was commercial rather than for "personal, family or household use," although a fact issue ordinarily would be generated. See *Lacey v. Baywood Truck & Mach.*, 381 So. 2d 863 (La. App. 1st Cir. 1980).

10. The parties signed one instrument, embodying both a "Sale and Chattel Mortgage," and a "Promissory Note," with no perforated line separating the two, and no other indication that the note was likely to be separated and enforced separately. 384 So. 2d at 389 n.1.

11. See note 4, *supra*.

12. See 15 U.S.C.A. § 45(m) (1979).

may have been a mistake regarding the inclusion of the clause, the bank nevertheless could not have reasonably expected to acquire holder in due course status, given the presence of the clause on the face of the contract. The supreme court thus characterized the FTC clause as simply a federally mandated stipulation whereby a buyer and seller agree, consistent with R.S. 10:1-102(3), to *vary* the effect of R.S. 10:3-305.<sup>13</sup> To so construe the effect of the FTC clause on the writing permits the writing to be characterized as "negotiable" for all purposes except holder in due course status. Had the court held negotiability to have been destroyed by the FTC clause, possessors of such contracts would also be denied the protection of R.S. 10:3-414,<sup>14</sup> and that of R.S. 10:3-417(2).<sup>15</sup>

While the effect of construing the FTC clause as merely an agreement by the parties to vary the effect of R.S. 10:3-305 will be to deny a third party holder the advantages of holder in due course status, the clause itself affords the buyer no greater substantive or procedural rights than he otherwise would have under state law. Thus, while the buyer may assert his claim in redhibition or his defense of seller nonperformance against the holder of the contract, neither the FTC clause nor the Preservation of Consumers' Claims and Defenses Rule itself in any manner aids the consumer in proving necessary ultimate facts. An example of the effect of the Rule is seen in the recent case of *General Motors Acceptance Corp. v. Daniels*,<sup>16</sup> involving a consumer automobile sale contract bearing the FTC clause. The buyer's dissatisfaction with the automobile led him to withhold the monthly payments, which in turn led to the filing by the creditor of a petition for executory process. The buyer, assert-

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13. The ability of the parties to vary the effect of the provisions of title 10 of the Revised Statutes is discussed in Hersbergen, *The Bank Customer Relationship Under the Louisiana Commercial Laws*, 36 LA. L. REV. 29 (1975).

14. An indorser, such as the seller in *Stamatiou*, engages to pay the tenor of the instrument to the *holder* or to any *subsequent indorser* who takes it up; if the writing had been characterized as "nonnegotiable," there would be no "holder," and in fact, no "indorsement." See LA. R.S. 10:3-202 (Supp. 1974). Cf. C. NORTON, *HAND-BOOK OF THE LAW OF BILLS AND NOTES*, § 57, 106 (2d ed. 1896) ("An indorsement is classed by itself as a distinct body of contract rights and liabilities. It has its origin in and is confined to the Theory of Negotiability."); *Bryant v. McGowan*, 151 Pa. Super. 529, 30 A.2d 667 (1943); *Young v. Sehon*, 53 W. Va. 127, 44 S.E. 136 (1903) ("The words 'indorser' and 'indorsement' as used in connection with the [liability] assumed by one merely writing his name on the back of the instrument, are technical words, applied only to negotiable paper.")

15. Under R.S. 10:3-417(2) Jefferson Bank would be the recipient of an implied warranty from the seller-transferor of the note that "no defense of any party is good against him," only if the transfer has been of an "instrument," i.e., a "negotiable instrument." See LA. R.S. 10:3-102(1)(e) (Supp. 1974).

16. 377 So. 2d 346 (La. 1979).

ing the pendency of an action in redhibition instituted by him against the seller in another judicial district, filed in the executory proceeding a petition for preliminary injunction to prevent a sheriff's seizure and sale of the vehicle. The Supreme Court of Louisiana conceded that in the absence of the FTC clause, a debtor could not assert an action in redhibition as the basis of enjoining executory proceeding instituted by a holder in due course, but denied the buyer's petition for preliminary injunction as unsupported by any showing that the redhibition action on which the preliminary injunction petition was premised was a meritorious action, under articles 3601 through 3609 of the Code of Civil Procedure.

By utilizing a contract form that does bear the FTC clause, the parties are ostensibly characterizing the transaction as a consumer transaction. The recent federal court decision in *International Harvester Credit Corp. v. Evans*<sup>17</sup> indicates that the presence of the FTC clause will not per se bring the transaction within the state's consumer credit laws. That is, the inclusion of the clause does not constitute an agreement by the parties that the transaction is to be governed by, for example, the Louisiana Consumer Credit Law.<sup>18</sup>

By analyzing the effect of the FTC clause from a contract or "agreement to vary" point of view, the supreme court's *Stamatiou* decision implicitly suggests that where the consumer signs an otherwise negotiable writing that should, but does not, contain the clause, a transferee or assignee will have the ability to prove holder in due course status. Of course, the holder of the contract can always attempt to show that the transaction is not a consumer transaction, as happened in *Lacey v. Baywood Truck & Machinery*,<sup>19</sup> a recent decision from Louisiana's First Circuit Court of Appeal. Several recent decisions involving analogous fact patterns support the view that the consumer contract that does not bear the required clause will be treated the same as a non-consumer contract. Many states have enacted section 2.403 of the Uniform Consumer Credit Code, a provision which prohibits the seller or lessor in a consumer credit transaction from taking a negotiable instrument (other than a check) as evidence of the obligation.<sup>20</sup> Section 2.403 adds that a holder is not a holder in due course if he takes a negotiable instrument with notice that it is (or has been) issued in violation of the section. Section 2.403 and the FTC Preservation Rule thus have a similarity in ap-

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17. 484 F. Supp. 1 (W.D. Okla. 1978).

18. *Id.* at 3; LA. R.S. 9:3514 (Supp. 1972). The United States District Court in *Evans* felt that the mere inclusion of the FTC clause did not sufficiently evidence an intent of the parties to make their transaction subject to the consumer credit laws.

19. 381 So. 2d 863 (La. App. 1st Cir. 1980).

20. *Cf.* LA. R.S. 9:3532(B) (Supp. 1972) (home solicitation sales).

proach: the burden of violation of the law is placed on the seller or lessor, not on the assignee creditor. In several cases, such creditors have been permitted to attempt to prove holder in due course status with respect to an evidence of indebtedness issued in violation of the prohibition of section 2.403.<sup>21</sup>

It would be misleading to conclude that "business as usual" will successfully guide the holder of a consumer contract that does not bear the FTC clause in his quest for holder in due course status, for although the contract will probably be negotiable, and the traditional legal standard—R.S. 10:3-305—will be applied, the road to section 3-305 must still pass through an intersecting section: 3-302(1)(b); that section could prevent acquisition of holder in due course status in a "clause-less" consumer contract case. Holder in due course status tends to be irrelevant in the absence of a claim or defense by the maker;<sup>22</sup> assume then, that a claim or defense does exist in favor of the consumer buyer who has signed a contract not bearing the required clause: to the extent that the contract is in negotiable form, the traditional ideas of good faith and lack of notice of claims and defenses would dictate holder in due course status in most cases. Certainly sections 3-302(1)(c) and 3-304 have not traditionally been applied to deny holder in due course status unless the holder not only knew when he acquired the instrument that it was issued in return for an executory promise, but also knew or had notice that a defense or claim had actually arisen,<sup>23</sup> or unless the instrument itself was "so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay."<sup>24</sup> Thus, the holder today can know that the transaction underlying the clause-less instrument may give rise to a defense or claim, and he still will be a holder in due course. Good faith, however, is also a prerequisite of holder in due course status, and that requirement most likely will be applied so as to defeat holder in due course status in cases involving nonlabelled consumer contracts.

At first glance, the requirement of good faith would not seem to pose a significant hurdle for the holder of a clause-less consumer contract in that the requirement expressly calls for no more than subjective honesty in fact.<sup>25</sup> But the subjective standard has not

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21. *Hinkle v. Rock Springs Nat'l Bank*, 538 F.2d 295 (10th Cir. 1976); *Circle v. Jim Walter Homes, Inc.*, 535 F.2d 583 (10th Cir. 1976); *Sherrill v. Frank Morris Pontiac-Buick-GMC, Inc.*, 366 So. 2d 251 (Ala. 1978). See *Pitts v. Henley*, 384 So. 2d 1105 (Ala. App. 1980); *Jefferson v. Mitchell Select Furn. Co., Inc.*, 321 So. 2d 216 (Ala. App. 1975).

22. See *Thrift Credit Corp. v. American Overseas Trading Corp.*, 387 N.Y.S.2d 930, 54 A.D. 2d 994 (1976).

23. LA. R.S. 10:3-304(4)(b) (Supp. 1974).

24. LA. R.S. 10:3-304(1)(a) (Supp. 1974).

25. LA. R.S. 10:1-201 (Supp. 1974) (definition of "good faith").



always been rigorously applied to cases involving consumer instruments, and has, in fact, earned the title of one of "the most slippery concepts" in the Uniform Commercial Code.<sup>26</sup> Thus, if one assumes that most consumer contracts that are assigned or transferred will be held by a commercially sophisticated institutional creditor, who knows or *should* know that the national public policy of the United States calls for the protection of consumers through a preservation of claims and defenses stipulation requirement on all consumer contracts affecting interstate commerce (and who, in the exercise of prudent business judgment will know a great deal about the general nature of the business of the seller he finances, and most probably the specific goods purchased in the transaction in question), that creditor will not be in good faith whenever he acquires, without inquiry or investigation, a consumer contract not bearing the required stipulation.<sup>27</sup>

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26. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 17-3, at 563 (1972). A discussion of the issue of good faith under the Louisiana Commercial Laws may be found in *The Work of the Louisiana Appellate Courts for the 1975-1976 Term—Commercial Paper and Bank Deposits and Collections*, 37 LA. L. REV. 406, 414-16 (1977) [hereinafter cited as *1975-1976 Term*].

The relationship between good faith and notice of defenses and claims is a close one. For example, if the provisions of R.S. 10:3-304(1)(2) or (3) apply, the holder can be denied holder in due course status either on the basis of notice of claims and defenses (or overdueness), or on the basis of lack of good faith. Good faith would be the more general of the two requirements. See LA. R.S. 10:1-203 (Supp. 1974). For example, a holder might be without "notice" of a claim or defense with respect to a particular instrument, but be in bad faith because he knows that numerous of the seller-payee's other instruments have in the past given rise to defenses and claims.

27. Most courts would agree with the following assessment of good faith, offered in *Stewart v. Thornton*, 116 Ariz. 107, 110, 568 P.2d 414, 417 (1977):

"Good faith" means honesty in fact in the conduct or transaction concerned. It entails the absence of bad faith and bad faith is dishonesty and absence of fidelity to the obligations of morals and honor. Bad faith is not just being careless. It is guilty knowledge or wilful ignorance. . . . To defeat the title of one otherwise a holder in due course who does not have knowledge of an infirmity or defect, there must be actual bad faith. Yet carelessness and failure to inquire under certain circumstances may constitute bad faith and it has been held that gross carelessness may constitute evidence of bad faith.

Among the numerous decisions finding bad faith in the acquisition of a consumer note or contract, or in cases relevant thereto, the following are exemplary: *Stewart v. Thornton*, 116 Ariz. 107, 568 P.2d 414 (1977) (holder charged with knowledge of the requirement of the Interstate Land Sales Full Disclosure Act that a land purchaser may revoke within forty-eight hours where the purchaser has received a required property report less than forty-eight hours before he signed the contract of sale, yet holder did not inquire as to such matters; held, bad faith could reasonably have been inferred by the trial judge); *Financial Credit Corp. v. Williams*, 246 Md. 575, 229 A.2d 712 (1967) (purchaser of note not in good faith where it was aware of the bad reputation of the payee and purchased the note as a part of a package of approximately 480 such instruments at a discount of over 80%); *Frye v. Farmers & Merchants Bank of Cape*

Because the FTC Rule merely leaves the consumer free to assert whatever claims and defenses he has under local law, sellers and financiers might well attempt to enhance the value of the consumer paper with which they deal by utilizing a waiver or renunciation of redhibition clause. Such a waiver clause was, in fact, a feature of the contract in *General Motors Acceptance Corp. v. Daniels*.<sup>28</sup> The response of the Louisiana Supreme Court was in the form of a reminder that three elements must exist before a valid waiver of implied warranty can be found: the waiver must be written in clear and unambiguous language, contained in the mortgage or other key transactional document, and either brought to the attention of the purchaser or explained to him.<sup>29</sup> The rigorous application of that three-part test has been detailed in a previous sym-

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Girardeau, 561 S.W.2d 392 (Mo. App. 1977) (holder not in good faith where it knew that the instrument taken was payment for a note which represented the personal obligation of an officer of the corporate maker, and knew, or is held to know, that personal obligations of a corporate officer cannot ordinarily be paid with corporate funds); *General Inv. Corp. v. Angelini*, 58 N.J. 396, 278 A.2d 193 (1971) (holder not in good faith in taking a home improvement contract, where holder was fully familiar with assignor's business and the terms of the contracts he used, among which terms was a stipulation that payments were due only after sixty days following completion of the project in a workmanlike manner, and holder neither inquired as to completion nor requested a certificate of completion which he must have known was required under New Jersey laws pertaining to home repair contracts, but relied solely on representations of the assignor). See generally Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 So. CAL. L. REV. 48 (1966).

The Official Comment to section 2.403 of the Uniform Consumer Credit Code (UCC), (see text at notes 20-21 *supra*.) indicates the view that the UCC prohibition against use of negotiable instruments in consumer transactions will become known in the financial community, so that professional financiers would thereby not usually qualify as holders in due course. However, in *Circle v. Jim Walters Homes, Inc.*, 535 F.2d 583, 587 (10th Cir. 1976), the court noted that a holder could nevertheless make the necessary showing of subjective good faith. See *Sherrill v. Frank Morris Pontiac-Buick-GMC, Inc.*, 366 So. 2d 251 (Ala. 1978). The most telling point is made in *Jefferson v. Mitchell Select Furn. Co., Inc.*, 321 So. 2d 216 (Ala. App. 1975), in which it is said of an instrument taken in violation of UCC section 2.403:

Though directing the consumer credit seller not to take negotiable paper, other than a check, as evidence of the obligation of the purchaser, [section 2.403] protects a holder in due course if such should be taken. Of course, it is difficult to conceive how one could be a holder of a negotiable instrument which showed that it was taken in the credit sale of consumer merchandise with retention of title and a purchase money security interest, without knowledge that it arose from a [consumer credit code] transaction.

*Id.* at 220. In short, the question becomes: is the holder believable when he says, "I didn't realize that the seller had, in this instance, entered into a consumer transaction"? See 1975-1976 *Term*, *supra* note 26, at 414-16.

28. See text at note 16, *supra*.

29. 377 So. 2d 346, 347-48 n.2.

posium contribution;<sup>30</sup> it is sufficient to observe that a contract which states both that the holder is subject to "all claims and defenses which the debtor could assert against the seller,"<sup>31</sup> and that the debtor waives the most important of the potential claims or defenses he might have, is a candidate for a ruling of ambiguity.<sup>32</sup> No doubt worthy of note in this context is the prohibition against waivers of implied warranties under the federal Consumer Product Warranties ("Magnuson-Moss") Act.<sup>33</sup>

The Preservation of Consumers' Claim and Defenses Rule, as promulgated in 1975, applied to two classes of consumer transactions: credit sales and leases of goods or services, and "purchase money loan" transactions for the financing of such sales and leases.<sup>34</sup> In the former category, a seller is prohibited under the Rule from using or taking a consumer credit contract not containing the required clause; in the latter category, the seller is prohibited from accepting, as full or partial payment for a consumer credit sale or lease, the *proceeds* of any loan obtained by the consumer that is a "purchase money loan," unless the consumer credit contract made in connection with the loan contains a substantially similar clause.<sup>35</sup> The Rule was addressed solely to the merchant; the "purchase money" lender was not affected. The FTC has recently approved "in substance" an amendment<sup>36</sup> to the 1975 Rule that would, among other things, extend the Rule to cover an "affiliated" lender,<sup>37</sup> making the lender liable to FTC sanctions if the promissory note it employs does not bear the required clause, when the lender knows

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30. *The Work of the Louisiana Appellate Courts for the 1978-1979 Term—Consumer Protection*, 40 LA. L. REV. 619, 619-23 (1980).

31. See note 4, *supra*.

32. Cf. *Jefferson Bank & Trust Co. v. Stamatiou*, 384 So. 2d 388, 391 (La. 1980) (insertion of the FTC clause into a nonconsumer contract can be viewed as ambiguous).

33. 15 U.S.C. § 2308 (1976).

34. See note 4, *supra*.

35. 16 C.F.R. § 433.2 (1980). See generally Hodge, *A Primer on the FTC's Rule Preserving Consumer Claims and Defenses*, 11 U.C.C.L.J. 354, 357-59 (1979). See note 4, *supra*.

36. See 44 Fed. Reg. 65771-74 (Nov. 15, 1979). The amendment had been proposed in November of 1975.

37. By "affiliation" the Rule intends a consideration of common control, or express or tacit business arrangements for the purpose of financing sales to consumers. See 41 Fed. Reg. 20022, 20026 (1976).

Banks regulated by the Federal Reserve System are not directly affected by FTC Trade Regulation Rules, but under the *FTC Improvement Act*, see note 3, *supra*, the FRB must implement the same rules as the FTC, unless the FRB can establish a good reason to exempt banks. Because the FTC amendment relies in part on FRB recommendations, there is no reason to suppose that banks will be exempted.

or should know that the purpose of the loan is to finance a purchase from an affiliated seller.<sup>38</sup>

#### ITEMS IN THE BANK COLLECTION PROCESS

##### *Payor Bank Accountability*

Prompt handling of items in bank channels is a major theme of Chapter 4 of the Louisiana Commercial Laws. The ordinary care required of a collecting bank<sup>39</sup> in presenting or sending an item for presentment, and in sending notice of dishonor or returning an item, is measured by the concept of the "midnight deadline."<sup>40</sup> When a demand item is presented for payment to a payor bank,<sup>41</sup> the payor bank likewise must act on it promptly. If the payor bank makes an authorized settlement for an item it has received (otherwise than "over the counter") before midnight of the banking day of receipt, R.S. 10:4-301(1) permits the payor bank to revoke the settlement and recover any payment it has made, if it so acts before it has made final payment<sup>42</sup> and before its midnight deadline.<sup>43</sup> If it retains the item beyond midnight of the banking day of receipt without so settling for it, or if after settlement it does not "pay or return the item or send notice of dishonor" until after its midnight deadline, the payor bank is accountable for the amount of the item.<sup>44</sup> With such important consequences confronting the payor bank, certainty as to the requirements of the law would be desirable, to say the least; such certainty is hampered by conflicting case law and by the effect on the Commercial Laws of "Regulation J."<sup>45</sup>

Under R.S. 10:4-302(a), a payor bank avoids accountability by settling for the item promptly and by observing the statutory command to "pay or return the item or send notice of dishonor" prior to

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38. The amendment would continue to make the affiliated seller liable to FTC sanctions if it accepts the proceeds of a loan from an affiliated lender when it knows the consumer obtained the loan from an affiliated lender, and the required clause was not included in the promissory note.

39. LA. R.S. 10:4-105(d) (Supp. 1974).

40. LA. R.S. 10:4-202(1) & (2); 4-104(h) (Supp. 1974).

41. LA. R.S. 10:4-105(b) (Supp. 1974).

42. LA. R.S. 10:4-213(1) (Supp. 1974).

43. LA. R.S. 10:4-301(1) (Supp. 1974). The section continues the "deferred posting" practice permitted by former R.S. 6:67 & 68.

44. LA. R.S. 10:4-302 (Supp. 1974). The accountability of a payor bank under section 4-302 is for the amount of the item; but the responsibility of a collecting bank for failure to use ordinary care (usually meaning seasonable action) in handling an item under section 4-202 presents a matter of proof of damages, whatever be the "amount of the item." See *Marcoux v. Mid-States Livestock, Inc.*, 429 F. Supp. 155 (N.D. Iowa, 1977), *aff'd*, 572 F.2d 651 (8th Cir. 1978); LA. R.S. 10:4-103(5) (Supp. 1974).

45. 12 C.F.R. § 210 (1980).

its midnight deadline. For dishonored items, then, section 4-302 appears to give the payor bank the option of returning the item or sending notice of its dishonor as the means of avoiding accountability. But under R.S. 10:4-301(1) a payor bank's ability to revoke a provisional settlement with the presenting bank depends on the *return* of the item before final payment and before the midnight deadline; sending notice of dishonor can only take the place of a return of the item *if* the item "is held for protest or is otherwise unavailable for return." The rule of thumb for the payor bank must be "return the item," rather than send notice of dishonor.<sup>46</sup> Yet, a Federal Reserve operating letter or circular authorizing telephonic notice can supersede the effect of section 4-301, as pointed out in the recent *Wells Fargo Bank v. Hartford National Bank & Trust Company*<sup>47</sup> decision from Connecticut, so that a payor bank's telephonic notice of nonpayment on a Friday to a collecting bank created for the collecting bank a midnight deadline of Monday for the giving of its own notice of dishonor, rather than a midnight deadline based on the day it actually received the returned item. In fact, a bank required to "wire advice of nonpayment" under the Federal Reserve operating circular must do so even where it has actually returned the item pursuant to R.S. 10:4-301; compliance with section 4-301 is, however, necessary to avoid accountability for the item.<sup>48</sup>

Regulation J is not just the concern of nationally chartered banks. A Ninth Circuit Court of Appeals decision in 1974 held that *any* bank which utilizes the check collection facilities of the Federal Reserve System by magnetic encoding of checks becomes subject to

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46. See *United States v. Loskocinski*, 403 F. Supp. 75 (E.D.N.Y. 1975); *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589 (Ky. App. 1977). R.S. 10:3-508 and 3-511, which arguably permit a different result in that a bank seemingly may give a written or even an oral notice of dishonor and be excused from any "notice" requirement, are rendered inapplicable to the issues of the revocation of settlements and accountability of payor banks by R.S. 10:4-102(1). *Valley Bank & Trust Co. v. First Security Bank of Utah*, 538 P.2d 298 (Utah 1975). *Contra*, *Security Trust Co. of New York v. First Nat'l Bank of Rochester*, 358 N.Y.S.2d 943 (Sup. Ct. 1974). Of course, a collecting bank or a bank handling a *collection* item such as a "payable through" draft, is not acting as a "payor bank" and consequently is not affected by sections 4-301 and 4-302, but would be governed by section 3-508.

47. 484 F. Supp. 817 (D. Conn. 1980) (construing Federal Reserve Operating Circular No. 6, 17(c), September 1, 1967). See *Security Bank & Trust Co. v. Federal Nat'l Bank & Trust Co. of Shawnee*, 554 P.2d 119 (Okla. App. 1976) (construing operating Letter No. 3, dated July 1, 1974, issued by the Federal Reserve Bank of Kansas City); LA. R.S. 10:4-103 (Supp. 1974). Operating circulars are issued by Federal Reserve Banks under the authority of Regulation J, 12 C.F.R. § 210.16 (1980).

48. *Colorado Nat'l Bank v. First Nat'l Bank*, 459 F. Supp. 1366 (W.D. Mich. 1978). A failure to return the item, and a failure to wire advice of nonpayment before the midnight deadline would result in liability for the face amount of the item.

Regulation J.<sup>49</sup> The importance of Regulation J goes well beyond the matter of handling dishonored items. A bank subject to Regulation J can, for example, revoke a settlement prior to its midnight deadline only if it settled for the item before the *close* of the banking day of receipt.<sup>50</sup>

In general, the Board of Governors of the Federal Reserve System, exercising regulatory power delegated by Congress, has attempted to conform Federal Reserve banking regulations to the Uniform Commercial Code. But Regulation J does preempt the Commercial Code in the case of a direct conflict, such as was presented in *Colonial Cadillac, Inc. v. Shawmut Merchants Bank, N.A.*<sup>51</sup> There, a dishonored \$7,300 draft left a payee wondering if the depository bank and the Federal Reserve Bank had given timely notice of dishonor. As a collecting bank, the Federal Reserve Bank is an agent or subagent of the owner of the item and must use ordinary care (usually meaning "midnight deadline") in sending notice of dishonor under R.S. 10:4-201, 4-202; as such, the bank could be liable to the payee-owner under the U.C.C. Under Regulation J, however, a Federal Reserve bank's liability is limited to those who "send" items to the Reserve banks.<sup>52</sup> Applying favorably to the Federal Reserve bank the test for preemption outlined by the Supreme Court,<sup>53</sup> the Massachusetts district court ruled that Regulation J preempted U.C.C. sections 4-201(1) and 4-202(1), with which it was in direct conflict on the issue of the liability of the bank; because the payee was not the "sender"<sup>54</sup> of the item, no claim for relief could be stated and the bank's motion to dismiss therefor was granted.

Approximately 25 billion checks are collected each year through the bank collection process, of which only one-half of one percent are dishonored upon presentment.<sup>55</sup> Of those checks dishonored upon in-

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49. *Community Bank v. Federal Reserve Bank of San Francisco*, 500 F.2d 282 (9th Cir. 1974), *modified*, 525 F.2d 690 (9th Cir. 1975), *cert. denied*, 419 U.S. 1089 (1974).

50. 12 C.F.R. 210.9(a) (1979).

51. 488 F. Supp. 283 (D. Mass. 1980).

52. 16 C.F.R. § 210.6 (1980). Section 210.2(e) defines a "sender" as "a member bank, a nonmember clearing bank, a Federal Reserve bank, an international organization or a foreign correspondent."

53. See *Jones v. Rath Packing Co.*, 430 U.S. 519 (1977), *applied in* *Doctors Hosp., Inc. v. Silva Recio*, 558 F.2d 619 (1st Cir. 1977).

54. See note 52, *supra*. When the "owner" of the item is also the "sender" of the item to the Federal Reserve bank, there is no conflict between Regulation J and the U.C.C.; but when the owner is a remote party, as would typically be the case, a conflict is presented.

55. Based on 1972 figures reported in *Community Bank v. Federal Reserve Bank of San Francisco*, 500 F.2d 282, 284 (9th Cir. 1974), *modified*, 525 F.2d 690 (9th Cir. 1975), *cert. denied*, 419 U.S. 1089 (1974). See Leary, *Check Handling Under Article Four of the Uniform Commercial Code*, 49 MARQ. L. REV. 331, 333 n.7 (1965).

itial presentment, about one-half are paid upon re-presentment.<sup>56</sup> Although low in relation to total volume, the number of checks placed in bank collection channels for re-presentment is quite significant, and the proper handling of the re-presented check is a matter about which courts do not agree. The disagreement concerns whether a re-presented check is to be handled by the payor bank as if it were any other check, with the midnight deadline setting the time limit for return upon dishonor, or whether the midnight deadline is somehow inapplicable to the re-presented check.<sup>57</sup> The stakes are high: to inaccurately predict the approach of the Louisiana courts could mean accountability under R.S. 10:4-302 for the payor bank that retains a re-presented check beyond the midnight deadline. The better view is that the re-presented check is in no way distinguishable from other checks, so that a payor bank's accountability is avoided only by a *return* of the check prior to the midnight deadline.<sup>58</sup>

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56. Leary, *supra* note 55.

57. Compare *Leaderbrand v. Central State Bank of Wichita*, 202 Kan. 450, 450 P.2d 1 (1969), and *Goodman v. Norman Bank of Commerce*, 551 P.2d 661 (Okla. App. 1976) (payor bank not required to send notice of dishonor of, or return, the re-presented check before the midnight deadline) with *Wiley v. Peoples Bank & Trust Co.*, 438 F.2d 513 (5th Cir. 1971), *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589 (Ky. App. 1977), and *Sun River Cattle Co. v. Miners Bank of Montana*, 164 Mont. 237, 521 P.2d 679 (1974) (midnight deadline applicable to re-presented check). See *David Graubart, Inc. v. Bank Leumi Trust Co.*, 48 N.Y.2d 554, 399 N.E. 2d 933 (1979); Note, *Uniform Commercial Code—Nonapplicability of Payor Bank's "Midnight Deadline" to Re-Presented Checks*, 18 Kan. L. Rev. 679 (1970).

58. The *Leaderbrand v. Central State Bank of Wichita*, 202 Kan. 450, 450 P.2d 1 (1969), and *Goodman v. Norman Bank of Commerce*, 551 P.2d 661 (Okla. App. 1976), cases exempt prompt handling of re-presented check upon reasoning that is flawed from two directions. First, the *Leaderbrand* decision in effect applied section 3-511(4) to a check; the section, which excuses notice of dishonor where a *draft* has been previously dishonored by nonacceptance, has absolutely no relevance to a check, and in any event would be preempted by the provisions of Chapter 4 of the Commercial Laws. Second, to analyze the problem in terms of the necessity of giving *notice* overlooks the requirement of sections 4-301 and 4-302 that the item itself must be returned unless it is unavailable for return. See text at note 46, *supra*. The most telling practical argument against the *Leaderbrand* analysis is put forth by the Kentucky court in *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589 (Ky. App. 1977):

If a payor bank was not required to meet its midnight deadline with respect to previously dishonored items, then none of the other banks involved in the collection process could safely assume that the check had been paid. Consider the problems of the depository bank. It must permit its customer to withdraw the amount of the credit given for the check when provisional settlements have become final by payment and the bank has had "a reasonable time" to learn that the settlement is final. See UCC § 4-213(4)(a). The depository bank will rarely receive notice that an item has been paid. In actual practice, the depository bank will utilize availability schedules to compute when it should receive the check if it is to be returned unpaid. If a payor bank is not bound by its midnight deadline as to previously dishonored items, then there is no way for the depository bank to

The midnight deadline is, however, a flexible concept. Affecting the payor bank's midnight deadline are holidays and other nonbanking days,<sup>59</sup> branch banks,<sup>60</sup> the afternoon cutoff,<sup>61</sup> and permissible delays.<sup>62</sup> A recent decision by New York's highest court suggests that if the midnight deadline is a problem, section 4-301(1) also provides a means of avoidance. In *David Graubart, Inc. v. Bank Leumi Trust Company*,<sup>63</sup> a previously dishonored check was redeposited and re-presented on a collection basis by direct send to the payor bank, accompanied by special directions to the payor well understood in banking practice to mean that such a re-presented item could be held for a reasonable time, even beyond the midnight deadline if necessary, to enable funds to come into the drawer's account. This procedure was categorized by the New York Court of Appeals as an "agreement," consented to by the depositor, which modified the effect of the midnight deadline requirement of section 4-302, and since there was no evidence that the payor bank had held the check for an unreasonable length of time, no accountability was created by retention beyond the midnight deadline.<sup>64</sup> An "agreement" it may have been; whether such an agreement permissibly varies the effect of the section 4-302 midnight deadline obligation, or impermissibly

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know whether a previously dishonored item has been paid upon re-presentment except by direct communication with the payor bank. Such a procedure would impose an unnecessary burden upon the check collection process.

*Id.* at 601 (citations omitted). An example of the point made in *Blake* is seen in *Manufacturers Hanover Trust Co. v. Akpan*, 398 N.Y.S.2d 477 (Civ. Ct. 1977). Whether or not a payor bank ought to return a re-presented check prior to its midnight deadline, the act of the holder in re-presenting a dishonored item could be viewed as a waiver of the notice of dishonor to which the holder would be entitled as an indorser under R.S. 10:3-501(2)(a), 3-508(2), and 4-207(2). See *Armour & Co. v. Guaranty State Bank*, 253 S.W. 1110 (Tex. Civ. App. 1923). Cf. LA. R.S. 10:3-511(2)(a), (b) (Supp. 1974).

59. LA. R.S. 10:4-104(1)(h) (Supp. 1974).

60. LA. R.S. 10:4-106 (Supp. 1974).

61. LA. R.S. 10:4-107 (Supp. 1974).

62. LA. R.S. 10:4-108 (Supp. 1974). Compare *Port City State Bank v. American Nat'l Bank*, 486 F.2d 196 (10th Cir. 1973) (computer "memory error") with *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 589 (Ky. App. 1977) (machine breakdowns and employee absences during Christmas holidays) and *Sun River Cattle Co. v. Miners Bank of Montana*, 164 Mont. 237, 521 P.2d 679 (1974) (transportation breakdown between bank and computer processing center).

63. 48 N.Y.2d 554, 399 N.E.2d 930 (1979).

64. The item was also accompanied by an "advice to customer" slip indicating that, as with collection items generally, credit would only be given to the depositor upon payment by the payor. The depositor was given a copy of the "advice" slip. Since no credit existed, the rationale of *Blake v. Woodford Bank & Trust Co.*, 555 S.W.2d 588 (Ky. App. 1977), see note 58, *supra*, is undisturbed by the holding in *David Graubart* that the midnight deadline was not applicable to the re-presented check.



varies the very *terms* of section 4-302, remains as the real issue of interest.<sup>65</sup>

The postdated check has long been a troublesome item for payor banks, and despite the fact that the Commercial Laws have clarified some of the older uncertainties attending its issuance and use,<sup>66</sup> the item remains a maverick to be handled with care. Prior to the stated date the item cannot be treated as "properly payable" but must be treated as a variety of conditional checks.<sup>67</sup> To pay prior to the stated date (the condition) is to pay with the payor bank's own funds—the prematurely paid postdated check cannot be charged against the drawer's account.<sup>68</sup>

It should follow that the payor bank is not confronted with the spectre of accountability if it, in effect, follows its customer's order by holding the postdated check beyond the normal midnight deadline. That method of handling postdated checks can be justified by simply characterizing the item as a draft, rather than a check, prior to the stated date; in effect, the postdated check would be a collection item, rather than a demand item for immediate payment.<sup>69</sup> A

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65. The Court of Appeals of New York obviously believed that the agreement only varied the effect of § 4-302; the Appellate Court of Illinois, in a case quite similar to *David Graubart*, expressed the contrary belief, although resolving the issue on the basis that, if the contract did exist, and if it could have permissibly released the bank from its obligation to return the item prior to the midnight deadline, the agreement in any event impermissibly attempted to disclaim the bank's obligation of good faith under sections 4-103(1) and 1-203. *Available Iron & Metal Co. v. First Nat'l Bank of Blue Island*, 56 Ill. App. 3d 516, 371 N.E.2d 1032 (1977). Section 4-103 is discussed in *Hersbergen*, *supra* note 13.

66. The character of the item as "negotiable" is not affected by the postdating, LA. R.S. 10:3-114(1) (Supp. 1974), and the fact of postdating does not affect the holder's ability to achieve holder in due course status. LA. R.S. 10:3-304(4)(a) (Supp. 1974).

67. The stated conclusion is drawn in part from R.S. 10:3-114(2) and in part from the obvious similarity such terms bear to a conditional check. *See Smith v. Maddox-Rucker Banking Co.*, 8 Ga. App. 288, 68 S.E. 1092 (1910). Labeling the prematurely presented postdated check as not properly payable does not truly do harm to payor banks; under section 4-407 the payor bank often may refuse to recredit the drawer's account on the basis of the bank's own subrogation rights.

68. *Smith v. Maddox-Rucker Banking Co.*, 8 Ga. App. 288, 68 S.E. 1092 (1910). Of course, the premature charge might well become proper whenever the stated date arrives with no stop payment order in the interim. But the premature depletion of the drawer's account may well result in the wrongful dishonor of subsequently presented, and otherwise properly payable items, on the basis of insufficient funds. The *Smith* case is an example: two wrongfully dishonored items would have "cleared" if the bank had not prematurely paid from the account a \$140 postdated check. The drawer of a postdated check simply does not undertake to have the funds to meet it in the drawer's hand prior to the stated date.

69. A check must, by definition, be "payable on demand." LA. R.S. 10:3-104(2)(b) (Supp. 1974). Yet, the postdated check is not payable until the stated date. LA. R.S.

recent federal district court decision from New York declined to adopt that view, with the result that the payor bank was held accountable under section 4-302 on a prematurely presented postdated check held beyond the midnight deadline. In *Allied Color Corp. v. Manufacturers Hanover Trust Company*<sup>70</sup> the postdated check was said, prior to its stated date, not to be a "check" but rather a "draft";<sup>71</sup> yet it was characterized as a "demand item" under section 4-302. The court believed that the label "demand item" represents a broader category than the label "payable on demand," and that the postdated check, in effect, is "payable on demand at a future date." The *Allied Color* decision requires a payor bank to handle the postdated check as if it were a routine demand item: if the item is not properly payable because its postdate has not arrived, it must be returned unpaid just as a countermanded check<sup>72</sup> is handled.

Regulation J seems to call for a result similar to that in the *Allied Color* case, in that payor bank accountability hinges upon retention of a "cash item" beyond the close of the paying bank's banking day on which the item was received.<sup>73</sup> The *Allied Color* case holds, however, that a postdated check prematurely presented for payment is not a "cash item." It is difficult to understand how a postdated check can be other than a "cash item" for purposes of Regulation J, and yet be a "demand item" for purposes of section 4-302. It is even more difficult to accept the correctness of the *Allied Color* decision. Assuming the correctness of the decision, however, accountability of the payor bank will, in most cases, mean that the item is thereby made one properly chargeable against the drawer's account. This is so because accountability cuts off the right of countermand,<sup>74</sup> and because accountability would most likely be the equivalent of payment for purposes of subrogation rights.<sup>75</sup>

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10:3-114(2) (Supp. 1974). Courts have occasionally held "bad check" laws inapplicable to the postdated check on the theory that such items are essentially promissory notes.

70. 484 F. Supp. 881 (S.D.N.Y. 1980).

71. See note 69, *supra*.

72. The holder of a postdated check is not required to present the item for *acceptance*, LA. R.S. 10:3-410 & 3-501(1) (Supp. 1974), but can do so if he desires. But under R.S. 10:3-503(1)(c), (e), and (2)(a), and 3-114(2), presentment for payment arguably is not due until the stated date. Accordingly, one could argue that the premature presentment for *payment* of a postdated check is not a timely presentment, and that the item must be returned as improperly presented.

73. 12 C.F.R. § 210.9(a)(1) (1980).

74. LA. R.S. 10:4-303(1)(e) (Supp. 1974).

75. LA. R.S. 10:4-407 (Supp. 1974). Thus, the ability of the payor bank to assert the rights of the payee will protect the bank whenever there is no drawer defense against the payee. To the extent a defense is involved, section 4-407 will usually clothe the

Banks may understandably desire to avoid the entirety of problems created by postdated checks and can likely do so by agreement. Thus, the bank may insert into the customer's checking account agreement a clause stipulating that postdated checks are not to be drawn at all, and/or if drawn, the drawer will indemnify the bank for all but negligence-premised liability.<sup>76</sup> Alternatively, correspondent banks could agree to handle and present postdated checks as collection items to be held for collection by the payor bank for a reasonable time.<sup>77</sup>

#### THE BANK-CUSTOMER RELATIONSHIP

##### *Charges On Overdraft Items*

When a check is presented against insufficient funds in the drawer's account, the drawee bank may properly pay that item, or it may properly dishonor it.<sup>78</sup> Although there is no apparent uniformity of approach by drawee banks to the routine handling of the overdraft item,<sup>79</sup> it is well established in Louisiana jurisprudence that the act of paying an overdraft item is in reality a loan of the overdraft amount to the customer, the item itself both impliedly requesting the loan and promising to repay it.<sup>80</sup> But upon what basis may a

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payor bank with the holder in due course rights of the depository bank. *Cf.* *Universal C.I.T. Credit Corp. v. Guaranty Bank & Trust Co.*, 161 F. Supp. 790 (D.C. Mass. 1958) (collecting bank a holder in due course). Alternatively, premature payments on postdated checks may be recoverable as not being "final" payments under R.S. 10:3-418 whenever the party paid is neither a holder in due course, nor has changed his position in reliance on payment. *See* *Delmar Bank v. Douglas*, 366 S.W.2d 80 (Mo. App. 1963).

76. *Compare* *Kalish v. Manufacturers Trust Co.*, 18 Misc. 2d 958, 191 N.Y.S.2d 61 (1959) *with* *Montano v. Springfield Gardens Nat'l Bank*, 207 Misc. 840, 140 N.Y.S.2d 63 (App. Term. 1955). The viability of such agreements under R.S. 10:4-103 is discussed in *Hersbergen*, *supra* note 13, at 43-55.

77. *See* text at notes 63-65, *supra*.

78. LA. R.S. 10:4-401(1) (Supp. 1974).

79. *Compare* *Orlich v. Rubio Sav. Bank*, 240 Iowa 1074, 38 N.W.2d 622 (1949), *and* *First Nat'l Bank of Murfreesboro v. First Nat'l Bank of Nashville*, 127 Tenn. 205, 154 S.W. 965 (1912), *with* *Bank of Jeanerette v. Druilhet*, 149 La. 505, 89 So. 674 (1921). Even if a bank has often, or even habitually, paid overdraft items, it is generally held that no continuing obligation to do so is thereby created in the absence of an express stipulation to that effect. H. BAILEY, *THE LAW OF BANK CHECKS* § 11.1 (4th ed. 1969). *See* *Modoc Meat & Cattle Co. v. First State Bank of Oregon*, 271 Ore. 361, 532 P.2d 21 (1975). It is the drawer that has initiated the circulation of an "NSF" check; he must bear the ultimate consequences of the handling of the item. *City Bank of Honolulu v. Tenn.*, 469 P.2d 816 (Hawaii 1970).

80. *Caddo Trust & Sav. Bank v. Bush*, 182 So. 397 (La. App. 2d Cir. 1938). *See* *Talbot v. First Nat'l Bank*, 106 Iowa 361, 76 N.W. 726 (1898). To the extent the overdraft check represents a consumer, rather than a commercial purpose, the bank presumably may charge up to the 36% rate ceiling of the Louisiana Consumer Credit Law. LA. R.S. 9:3419(A)(1)(a) (Supp. 1972 & 1980).

drawee bank impose a charge when it dishonors an overdraft item? A persuasive New York decision has recently taken the position that charging the drawer for handling his dishonored overdraft items must have a contractual foundation; if not, such charges may not be imposed.

The drawee bank in *Clark v. Marine Midland Bank, Inc.*<sup>81</sup> had imposed a "service" charge of \$4 to \$5 for each of its customer's checks not honored because of insufficient or uncollected funds. No authority for such charges could be found in the checking account agreement signed by the customer.<sup>82</sup> In denying a motion of the bank to dismiss the customer's action for failure to state a cause of action, the New York court stated:

[I]t must be assumed that the agreement between each customer and defendant was intended to express the whole contract between the parties. This is the common-sense, everyday understanding of a checking account agreement between customer and bank. Implicit in such an agreement is the promise by the bank that there would be no penalty or charge imposed upon the customer with reference to his or her checking account or checking activity other than as specified in the agreement.<sup>83</sup>

Given the application to the checking account agreement of Civil Code article 1958, the *Clark* position almost certainly would be viewed favorably in Louisiana, at least with respect to noncommercial customers.<sup>84</sup>

The payee or other holder of a check destined to be returned for insufficient funds has often transferred the check to a merchant who, in turn, has deposited the check for collection; very often, the merchant seeks to impose upon the transferor a "returned check" charge of, for example, \$5 or more. Upon the same premise that un-

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81. 413 N.Y.S.2d 9 (App. Div. 1979).

82. The action was instituted on behalf of the class of checking account customers having suffered the imposition of "NSF" charges. Defendants in the suit included Chase Manhattan Bank and Marine Midland Bank.

83. 413 N.Y.S.2d at 11.

84. Cf. *Davis v. Miller Builders & Developers, Inc.*, 340 So. 2d 409, 412 (La. App. 2d Cir. 1976). ("The relationship between . . . a depositor and . . . the depository bank, is that of creditor . . . and debtor . . . . [The depository bank] was not authorized to debit [the depositor's] account without [his] authority"). Cf. *Thomas v. Marine Bank & Trust Co.*, 156 La. 941, 101 So. 315 (1924) (setoff must be contractual). The argument that such charges are "customary" in banking practice would be met by the requirement that the commercially sophisticated party must explain such esoteric matters to the layman. See, e.g., *Larriviere v. Roy Young, Inc.*, 333 So. 2d 254 (La. App. 3d Cir. 1976); *Deutschmann v. Standard Fur Co., Inc.*, 331 So. 2d 219 (La. App. 4th Cir. 1976); *Leithman v. Dolphin Swimming Pool Co.*, 252 So. 2d 557 (La. App. 4th Cir. 1971).

derlies the *Clark* decision, such charges may be valid, as a part of the agreement between the transferor and the merchant. By the act of giving the check, the transferor can be found to have accepted the merchant's returned check terms if those terms were clearly stated, such as in prominently posted notices. Such was the holding in *Merrel v. Research & Data, Inc.*<sup>85</sup> The merchant's returned check charge in *Merrel*—\$5, plus 10 percent of the face value on checks of over \$20 in amount—was found to be reasonable, given the unexpected bookkeeping involved, but the court did not give blanket approval to such charges.

#### *The Customer's Duties Under Section 4-406*

As a general matter there is no significant difference between an item bearing a forged necessary indorsement and one that is missing a necessary indorsement. In either case, the subsequent possessor of the item cannot be a holder, and the payor bank cannot properly debit such an item to its drawer-customer's account.<sup>86</sup> Under section 4-406, however, the customer is bound only to exercise reasonable care and promptness to examine his account statement and the items the bank has paid to discover his unauthorized signature (or any alteration on an item);<sup>87</sup> he is not obligated to promptly discover unauthorized indorsements.<sup>88</sup> As applied to checks drawn against sole-signature accounts, and checks issued to sole payees, section 4-406 has created no controversy. The drawer must discover and report promptly his unauthorized signature; he has no obligation to discover and report promptly the unauthorized, or missing, indorsement of the payee.

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85. 3 Kan. App. 2d 48, 589 P.2d 120 (1979).

86. *Davis v. Miller Builders & Developers, Inc.*, 340 So. 2d 409 (La. App. 2d Cir. 1976); *Ford Motor Credit Co. v. United Serv. Auto. Ass'n*, 11 U.C.C. Rep. 361 (N.Y.C. Civ. Ct. 1972). It is not the presence of an unauthorized signature, placed on the instrument by someone else, that is significant; rather, it is the *absence* of a signature by the party who should have indorsed, that defeats negotiation (and therefore holder status) and also renders the item not "properly payable." The presence of an unauthorized indorsement on the instrument does have implied warranty consequences under R.S. 10:3-417, 4-207. Additionally, banks handling the missing indorsement item face liability under R.S. 10:3-419(1). See *Gast v. American Cas. Co.*, 99 N.J. Super. 538, 240 A.2d 682 (1968).

87. LA. R.S. 10:4-406(1) (Supp. 1974).

88. *East Gadsden Bank v. First City Nat'l Bank of Gadsden*, 5 Ala. App. 576, 281 So. 2d 431 (1973). Comment 5 to section 4-406 recognizes that there typically is no reason for drawer examination of indorsements because the drawer will not be familiar with the payee's signature. The three-year outside limit in section 4-406(4) for *asserting* unauthorized indorsements recognizes that the drawer will discover such problems only through notification to him by the payee or other parties. See *G & R Corp. v. American Sec. & Trust Co.*, 523 F.2d 1164, 1170 (D.C. Cir. 1975).

A significant disagreement has developed, however, concerning the application of section 4-406 to checks that are drawn against multiple-signature accounts but signed by less than all the required signatories and to checks drawn and issued jointly to multiple payees, paid by the drawee despite the absence of indorsements by all such payees. It is a common requirement of the checking account agreements of entities such as corporations, partnerships, joint ventures, and trust funds, that checks only be paid on two or more specified signatures. When a check is paid despite the absence of one of the required signatures, the bank has paid an improperly payable item and must recredit the entity's account unless it has a defense thereto. Section 4-406, in sub-sections (1) and (4), provides such a defense in the case of unauthorized signatures; but is the sole signature of partner A, on a partnership check that should also have been signed by partner B, an "unauthorized" signature? If two or more individual signatures are viewed as necessary to form the signature of the entity, then the missing individual signature can render the entity's signature incomplete and, for that reason, unauthorized<sup>89</sup> within the meaning of section 4-406(1) and (4).<sup>90</sup> But, con-

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89. R.S. 10:1-201 defines an "unauthorized" signature or indorsement as "one made without actual, implied or apparent authority and includes a forgery."

90. The stated view was taken by the Supreme Court of Arkansas in *Pine Bluff Nat'l Bank v. Kesterson*, 520 S.W.2d 253 (Ark. 1975), a case involving a trust fund drawer whose "authorized" signature was to consist of the joint signatures of three trustees. The court took the view that any purported signature of the trust fund not consisting of all three signatures was an unauthorized signature, even though the one or two individual signatures themselves were authorized and proper. Two courts do not agree with the Arkansas decision. In *Wolfe v. University Nat'l Bank*, 270 Md. 70, 310 A.2d 558 (1973), section 4-406(1) was held inapplicable to partnership checks bearing only one of two required partner's signatures, the court focusing primarily on the fact that the checks bore no unauthorized individual signatures, i.e., the only signatory was in fact an authorized signatory. That approach was expressly repudiated by the Arkansas court. But the United States Court of Appeals for the District of Columbia, in *G & R Corp. v. American Sec. & Trust Co.*, 523 F.2d 1164 (D.C. Cir. 1975) agreed with the view of the Maryland court in *Wolfe* that the absence of one of two or more required signatures does not constitute the unauthorized signature of an entity under section 4-406. The decision, which involved a joint venture checking account, conceded the plausibility of the Arkansas court's approach to section 4-406, but concluded that section 4-406 was not intended to place the responsibility for discovery of the missing individual signature on the drawer, in view of the ease with which the bank could protect itself by consulting the signature card. That point is a valid one, but not a telling one. Drawee banks will probably not be successful in the entity-drawer cases—even in Arkansas—under section 4-406(1), because under section 4-406(3) it would seem rather easy for the entity to establish the bank's lack of ordinary care in paying such an item without consulting the signature card; in such a case, the preclusion defense of subsections (1) and (2) is not available to the bank. Subsection (4), however, expressly operates independently of subsections (1), (2), and (3); that is, even the negligent bank can raise the one-year bar against a non-negligent customer. For that reason, the focus of

ceding such to be a valid analysis of section 4-406, it does not follow that the drawer must, either promptly or within three years, discover and report a missing joint-payee signature;<sup>91</sup> such is, however, the recent holding of the Supreme Court of Georgia in *Trust Company Bank v. Atlanta IBM Employees Federal Credit Union*.<sup>92</sup> Other U.C.C. decisions and pre-Commercial Laws decisions in Louisiana do not agree with the Georgia case.<sup>93</sup>

#### RASCALITY AND THE CONSEQUENCES OF DRAWER NEGLIGENCE

Checks in payment of insurance claims are often issued by the insurer-drawer payable jointly to the insured-claimant and the repairman—a perfectly acceptable custom, but one fraught with rascality potential. For instance, the drawer cannot deliver the joint-payee check to both payees, an important consideration in light of the requirement that both joint payees must indorse in order to negotiate the instrument.<sup>94</sup> According to the fourth circuit decision in *Koerner & Lambert v. Allstate Insurance Company*,<sup>95</sup> the drawer must be greatly concerned about the possibility that the recipient-

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these cases must be on subsection (4), and in that respect, the Arkansas view seems preferable.

91. No case has suggested that a drawer must discover and report the missing indorsement of a sole payee, and traditionally that has been the burden of the collecting and paying banks. See *Davis v. Miller Builders & Developers, Inc.*, 340 So. 2d 409 (La. App. 2d Cir. 1976); *Trouard v. First Nat'l Bank of Lake Charles*, 247 So. 2d 607 (La. App. 3d Cir. 1971); *Allan Ware Pontiac, Inc. v. First Nat'l Bank of Shreveport*, 2 So. 2d 76 (La. App. 2d Cir. 1941).

92. 264 S.E.2d 202 (Ga. 1980). The decision applies section 4-406(4) to a check missing one of two joint-payee indorsements.

93. In *Davis v. Miller Builders & Developers, Inc.*, 340 So. 2d 409, 412 (La. App. 2d Cir. 1976), for example, the court said of the payment of a check not indorsed by the sole payee:

It is the duty of the drawee bank to require indorsement by the payee before paying a check. The drawer may assume that the drawee paid upon a proper indorsement and in the absence of gross negligence on the drawer's part, the drawer is under no duty to discover that payment was made without proper indorsement.

And in *Trouard v. First Nat'l Bank of Lake Charles*, 247 So. 2d 607, 610-11 (La. App. 3d Cir. 1971), it was said of a check bearing a forged payee indorsement: "it was the duty of the banks involved, including the drawee bank . . . , to require the endorsement of the named payee prior to payment [and] the drawer . . . has no duty to discover that payment was made upon an improper endorsement. . . ." Two U.C.C. decisions have held § 4-406(4) inapplicable to the check missing a signature of one of the joint payees. *Phoenix Assur. Co. v. Davis*, 126 N.J. Super. 379, 314 A.2d 615 (1974); *Ford Motor Credit Co. v. United Serv. Auto. Ass'n*, 11 U.C.C. Rep. 361 (N.Y.C. Civ. Ct. 1972). Both decisions reason that section 4-406(4) should not bar drawer redress where there is so patent a breach of the payor bank's contractual obligation.

94. LA. R.S. 10:3-116 & 3-202 (Supp. 1974).

95. 374 So. 2d 179 (La. App. 4th Cir. 1979).

payee will forge the indorsement of the nonrecipient-payee. In *Koerner & Lambert* a joint payee draft was sent by the insurer-drawer to the payee-repairman upon whose estimate of cost to repair the payee-insured's boat the draft had been issued. The drawer did not notify its payee-insured that the draft had been issued as a joint payee instrument and had been sent to the repairman. This oversight became significant when the repairman did not perform the repairs, but did transfer the draft to his lawyer for the purpose of payments to his creditors. The lawyer deposited the draft for collection, disbursing funds to creditors of his repairman-client only when the draft had been paid by the drawee. The drawer ultimately discovered that its insured had received neither repairs nor payment of the claim and demanded, on the basis of the payee-insured's affidavit as to the forgery of his signature, that the drawee recredit its account. The drawee did so, and in turn demanded and received reimbursement from the depositary bank,<sup>96</sup> which in turn debited the lawyer's account.<sup>97</sup> The lawyer sued the drawer-insurer.

The fourth circuit held that the drawer's issuance of a joint-payee check to the repairman without notification to its insured-claimant was negligence, which under R.S. 10:3-406 estopped the drawer from claiming in the lawyer's suit against it that the lawyer had breached the implied warranty of good title made by one who obtains payment.<sup>98</sup> Assuming the validity of the court's resolution of the negligence issue, the court reached a defensible result by the wrong route.

For the predictable but unpreventable case of rascality presented by *Koerner & Lambert*, the Louisiana Commercial Laws provide a scheme by which the inevitable losses are distributed. When the instrument has not been finally paid, the losses are usually distributed pursuant to the provisions of the Commercial Laws pertaining to the liability on the instrument of drawers and indorsers<sup>99</sup> and those pertaining to the implied warranties of transferors.<sup>100</sup> *Koerner & Lambert* involved an item that had been paid, and for

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96. See LA. R.S. 10:4-207(1)(a) (Supp. 1974).

97. See LA. R.S. 10:4-207(2)(a) (Supp. 1974). The case actually involved two drafts issued to two different claimants, each of whom dealt with the same nonperforming repairman.

98. LA. R.S. 10:2-417(1) (Supp. 1974).

99. LA. R.S. 10:3-413(2) & 3-414 (Supp. 1974).

100. Transferors outside of bank channels make implied warranties under R.S. 10:3-417(2), but the depositor (usually the holder or owner of the item) and collecting banks make implied warranties under R.S. 10:4-207(2). The two subsections are substantially identical.



such cases other provisions of the Commercial Laws come into play, most notably those pertaining to the implied warranties made by those who obtain payment,<sup>101</sup> and to the rights of the "true owner" of the instrument.<sup>102</sup> Additionally, in forged indorsement cases there exists a creditor (typically the payee) who can claim the undischarged underlying obligation<sup>103</sup> of the drawer or other debtor.

In *Koerner & Lambert* the payee-claimant had a contractual right to be paid on his claim, and because payment was not made to him or for his benefit, he had an undisputable claim against the drawer. The drawer, in turn, had a legitimate complaint against the drawee because the draft was not paid upon the authorized signature of both payees.<sup>104</sup> Drawees, however, are protected under R.S. 10:3-406 from claims for reimbursement where, although they have paid the instrument over an unauthorized indorsement, the negligence of the party claiming reimbursement "substantially contributes" to the making of the unauthorized indorsement. Given the *Koerner & Lambert* holding on the issue of the drawer's negligence, the drawee could—and should—have defended the drawer's reimbursement claim; had it done so, the controversy would have been quickly resolved by leaving the loss with the drawer.<sup>105</sup> Drawees who cannot defend the drawer's claim for reimbursement are protected by the implied warranties made by the party obtaining the (mistaken) payment or from the collecting banks which forwarded the item paid.<sup>106</sup>

The policy question indirectly raised in *Koerner & Lambert* is whether a drawee should be able to claim implied warranty protection after it has foregone or waived its rights under section 3-406 as

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101. LA. R.S. 10:3-417(1) & 4-207(1) (Supp. 1974).

102. LA. R.S. 10:3-419(1) (Supp. 1974). See *Smith v. General Cas. Co. of Wis.*, 75 Ill. App. 3d 971, 394 N.E.2d 804 (1979).

103. The underlying obligation is typically discharged only by a payment of the instrument issued to the creditor; but payment will create a discharge defense for the drawer, maker, or other debtor only when the *holder* receives the payment. LA. R.S. 10:3-603 (Supp. 1974). When a necessary indorsement has been forged, there can be no subsequent holder of the instrument, LA. R.S. 10:3-202(1), (2) (Supp. 1974), and consequently, no discharge by payment.

104. LA. R.S. 10:3-116(b) & 4-401(1) (Supp. 1974).

105. See, e.g., *Fidelity & Cas. Co. of New York v. Constitution Nat'l Bank*, 167 Conn. 478, 356 A.2d 117 (1975); *Park State Bank v. Arena Auto Auction, Inc.*, 59 Ill. App. 2d 235, 207 N.E.2d 158 (1965); *Thompson Maple Prods., Inc. v. Citizens Nat'l Bank of Corry*, 234 A.2d 32 (Pa. Super. 1967). But see *Guardian Life Ins. Co. of America v. Chemical Bank*, 47 A.D.2d 608, 363 N.Y.S.2d 820 (1975); *Society Nat'l Bank of Cleveland v. Capital Nat'l Bank*, 30 Ohio App. 2d 1, 281 N.E.2d 563 (1972). See also *Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 491 F.2d 192 (8th Cir. 1974).

106. LA. R.S. 10:3-417(1) & 4-207(1) (Supp. 1974).

against the drawer. Courts might predictably estop the drawee from subsequently claiming warranty protection in such a case,<sup>107</sup> but even if the drawee in *Koerner & Lambert* could have legitimately claimed its implied warranty protection against the depository bank, and that bank in turn have debited (by setoff) the lawyer's account,<sup>108</sup> the lawyer would thereby have had no warranty claims against the drawer,<sup>109</sup> and he would not be the "true owner" for purposes of section 3-419(1);<sup>110</sup> only if he could obtain possession of it could he sue the drawer "on the instrument."<sup>111</sup> Because a drawer only engages to pay the holder or an indorser who takes up the instrument,<sup>112</sup> the lawyer would have to prove his holder status—a difficult task given the existence of the forged indorsement—and while section 3-406 is a great comfort to a "drawee or other payor," it is not of great assistance to one not a holder in due course. Contrary to the holding of the *Koerner & Lambert* case, the lawyer-plaintiff was not a holder in due course, who is therefore protected by section 3-406; in fact, he was not even a holder. Overlooked by the fourth circuit in *Koerner & Lambert* is the inherent circuity of thought in section 3-406: an unauthorized indorsement may not be asserted by a

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107. R.S. 10:4-406(5) provides that "if under this section" a payor bank has a valid defense against the customer's claim of wrongful payment, but waives or fails upon request (of the owner of the item or one of the collecting banks involved, presumably) to assert the defense, then the payor bank "may not assert against any collecting bank or other prior party presenting or transferring the item a claim based upon the unauthorized signature or alteration giving rise to the customer's claim." The language "under this section" clearly precludes direct application of subsection (5) to the case in which a payor bank has only a section 3-406 defense against the drawer's claim. One court, however, has applied the same principle to the section 3-406 cases, perhaps as a matter of equitable estoppel under section 1-103 (R.S. 10:1-103). *Canadian Imperial Bank of Commerce v. Federal Reserve Bank*, 64 Misc. 2d 959, 316 N.Y.S.2d 507 (1970). *Cf. Sun 'N Sand, Inc. v. United Cal. Bank*, 148 Cal. Rptr. 329, 582 P.2d 920 (1978) (drawer action against collecting bank). *But see East Gadsden Bank v. First City Nat'l Bank of Gadsden*, 281 So. 2d 431 (Ala. App. 1973).

108. Depositors of items make both implied warranties and an engagement to "take up" the item upon dishonor. LA. R.S. 10:4-207(2) (Supp. 1974).

109. Drawer did not "transfer" the item within the meaning of R.S. 10:3-417(2), and drawers make no warranties under section 3-417(1).

110. Although "owner" and "holder" are closely related terms in the Commercial Laws, they are not identical; still, a "trueowner" who is not the holder and is not otherwise entitled to payment, does not benefit from R.S. 10:3-419(1). By contrast, the payee-insured, who never had possession of the instrument, is not necessarily to be regarded as its true owner. *See Twellman v. Lindell Trust Co.*, 534 S.W.2d 83 (Mo. App. 1976). *But see Berkheimers, Inc. v. Citizens Valley Bank*, 529 P.2d 903 (Ore. 1974) (permitting a section 3-419 action by a non-indorsing co-payee).

111. LA. R.S. 10:3-301 (Supp. 1974).

112. LA. R.S. 10:3-413(2) (Supp. 1974).

negligent party against a holder in due course, which the plaintiff could not be if the indorsement was unauthorized.<sup>113</sup>

Unlike sections 3-419(1), 3-413, 3-414, 3-417, and 4-207, section 3-406 does not yield a basis for a plaintiff's suit against the negligent party; rather, it merely describes a *preclusion* device designed to prevent the assertion of the truth in circumstances in which it would be highly unfair for the truth to be heard. Section 3-406 does not permit one party to sue another party upon a claim of injury or loss caused by a negligent act; such an action is not prohibited by the Commercial Laws, but is unrelated to section 3-406.<sup>114</sup> The most significant aspect of *Koerner & Lambert* is not, however, the possible misunderstanding of section 3-406, but the matter of what constitutes negligence under that section. If the fourth circuit is correct on the negligence issue, the issuance of joint-payee checks will require reexamination.

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113. Most aspects of section 3-406 are without ambiguity. A drawee can be protected in alteration cases and in cases involving unauthorized signatures of either the drawer or of the payee and subsequent holders. Likewise, one can be a holder—and therefore a holder in due course—of an instrument that has been altered or bears an unauthorized drawer or maker's signature, LA. R.S. 10:3-404(1) (Supp. 1974), and he can obviously use the shelter of section 3-406. But once there is an unauthorized necessary indorsement, only a drawee or other payor can logically qualify for the section 3-406 protection.

The circuitry may be more apparent than real. Holders will typically allege that they are holders in due course, though such need not be proven until it is shown that a defense exists. LA. R.S. 10:3-307(3) (Supp. 1974). Where the instrument is in negotiable form, and the defendant does not raise the requirements of section 3-302, it appears that the courts are either assuming holder in due course status for purposes of the section 3-406 issue, or are simply applying equitable estoppel via section 1-103 to preclude the negligent party from raising the harsh truth that without the necessary authorized signature, plaintiff cannot be a holder in due course. If defendant is precluded from raising the only possible infirmity in the plaintiff's status, the allegation that he is a holder in due course will be uncontroverted. An example of the application of equitable estoppel to an unauthorized indorser's signature is found in *Gluckman v. Darling*, 85 N.J.L. 457, 89 A. 1016 (1914).

114. See LA. R.S. 10:1-103 (Supp. 1974).